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2024 Deal Survey of Independent Sponsor-Led Transactions

Introduction

We are proud to present the 2024 edition of the McGuireWoods independent sponsor deal survey. This survey is based on the results of more than 300 responses, which cover transactions that were closed in 2021, 2022 and 2023, making this the largest and most robust study of its kind.

This survey covers transactions spanning both the white-hot private equity market that prevailed post-pandemic and the more subdued private equity market that has settled in since 2022. Through those market fluctuations, independent sponsors have continued to raise capital and close transactions as a growing force within the private equity ecosystem.

The study discusses the most useful findings of our survey data and identifies prevailing market trends in economic and other terms of independent sponsor transactions. The study focuses primarily on control investments led by independent sponsors and financed by various partners who provide capital.

This study was authored by McGuireWoods private equity attorneys Greg Hawver, Jason Griffith, Jeff Brooker, Jon Finger and Andrew Steiger together with invaluable input from the McGuireWoods competitive intelligence team and, of course, the many independent sponsors and capital partners in our network who completed deal surveys.

Please do not hesitate to contact the authors of this deal study with any questions regarding the findings or the underlying survey data.

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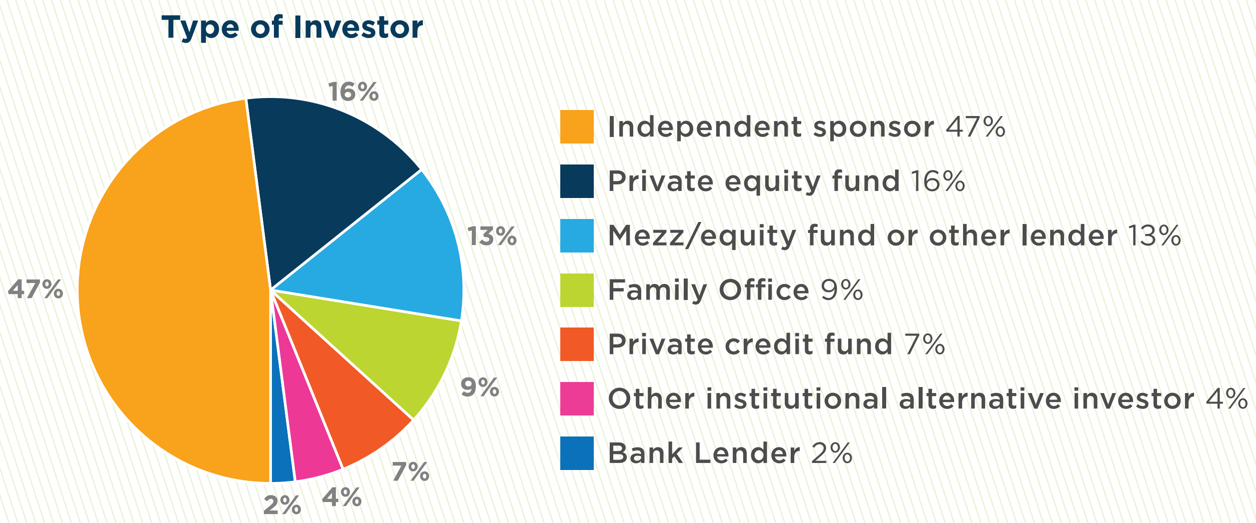
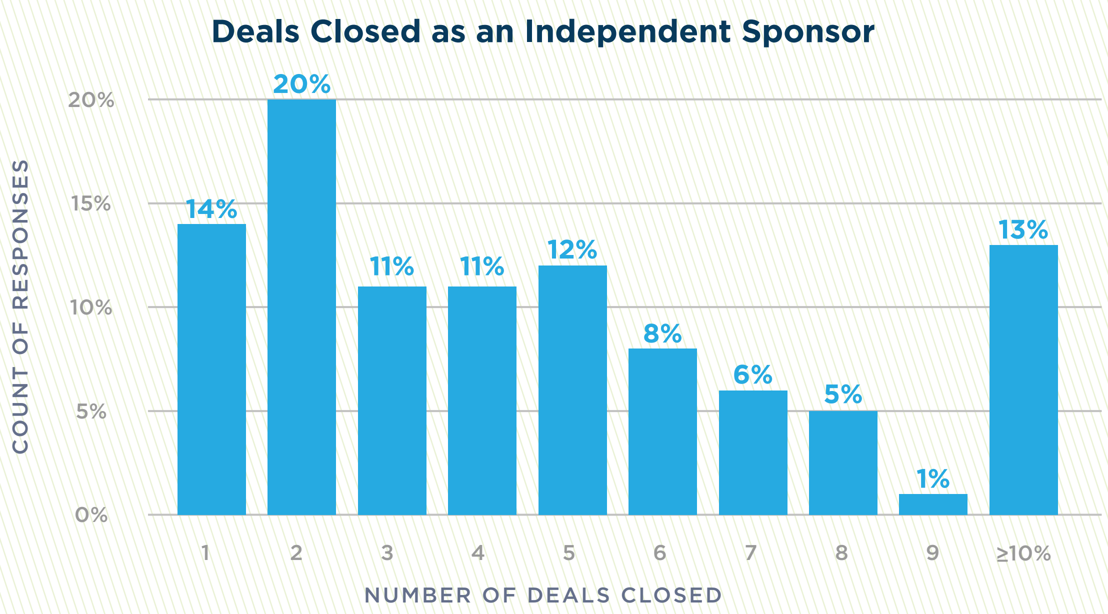
Breakdown of Survey Respondents

Type of Investor. The mix of independent sponsor and capital partner respondents to our survey was very balanced. Mezzanine debt/equity funds and private equity funds were the two most common capital partner participants. SBIC funds represented a very active subset of the market.



Experience. New for this survey, we polled independent sponsor respondents to determine their experience level based on number of transactions closed. Respondents ranged from first-time independent sponsors to independent sponsors who have led over ten investments.



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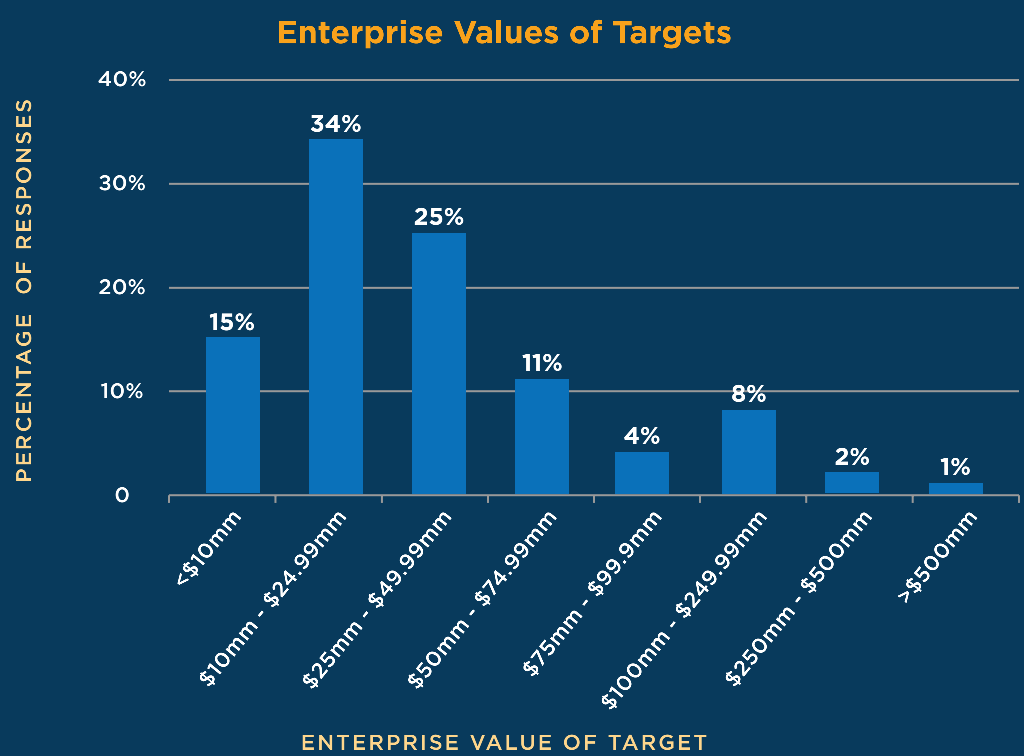
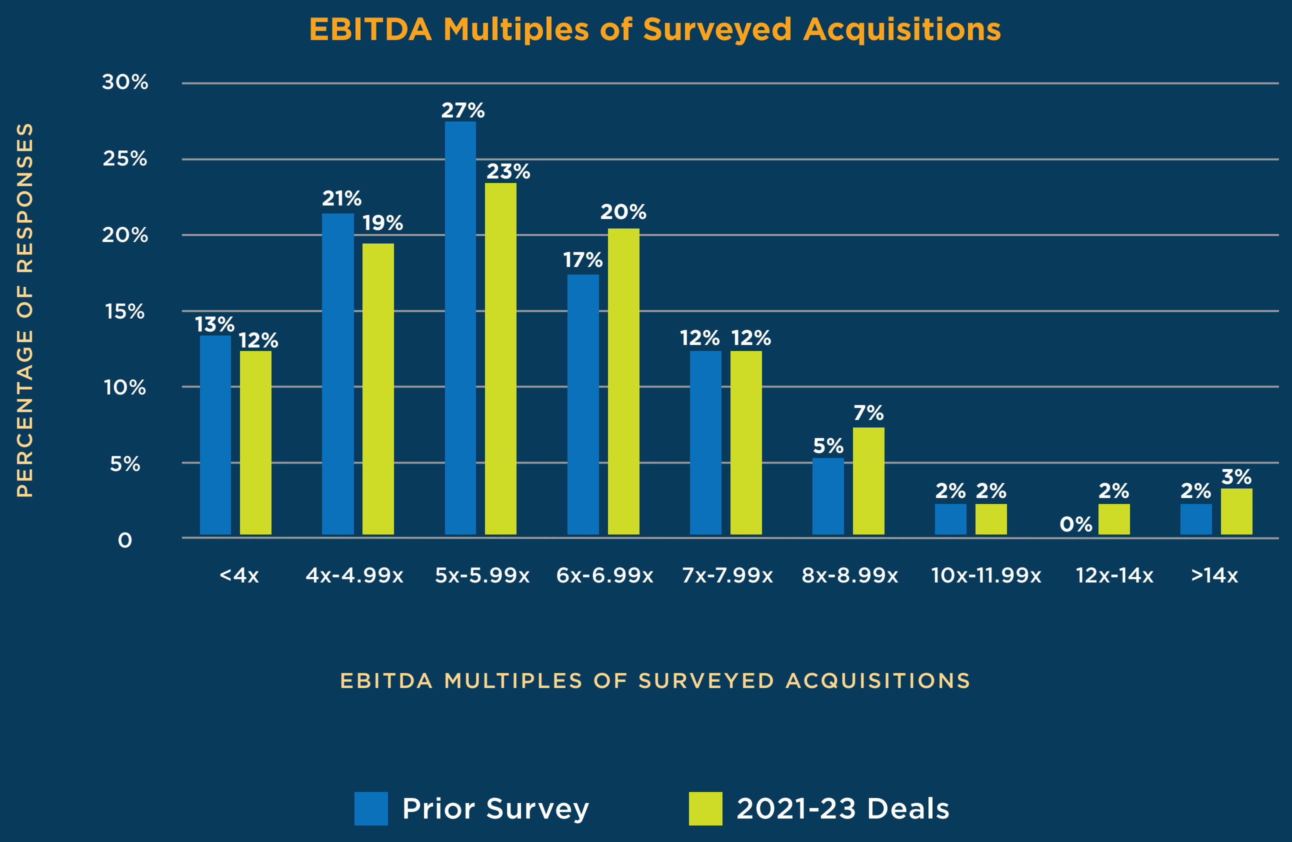
Size and Pricing of Transactions Surveyed

Enterprise Value. More than 75% of the transactions surveyed involved target companies with an enterprise value between $10 million and $75 million, which based on our experience is the most active band for independent sponsors. Deals exceeding $100 million in enterprise value represented more than 10% of the deals surveyed, which is a 50% increase from the prior survey and reflects the growing prominence of the independent sponsor segment within private equity.



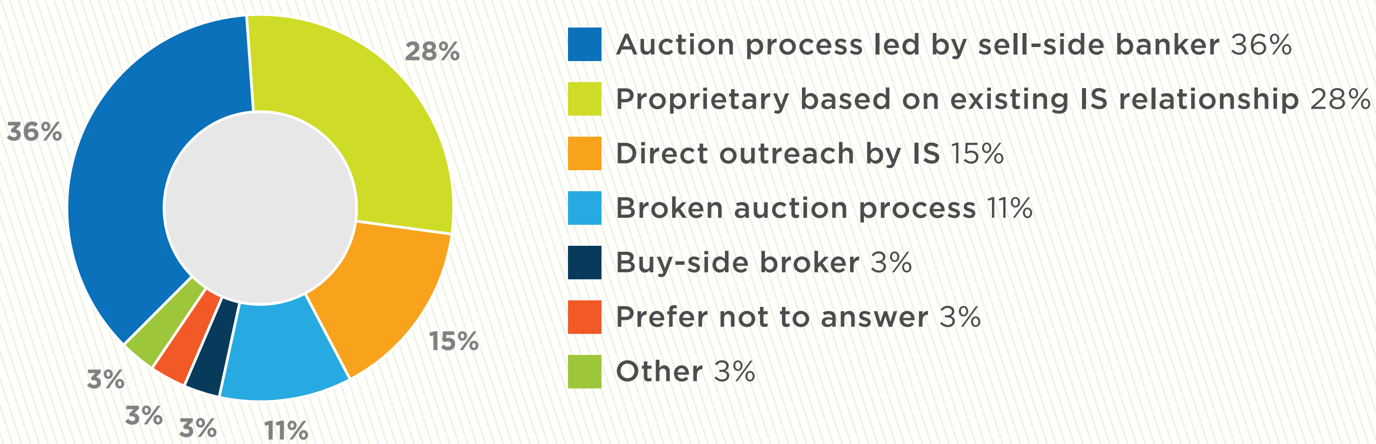
EBITDA Multiples. The pricing of most independent sponsor transactions reflects reasonable multiples of EBITDA. We note, however, that the prevalence of deals being closed with multiples between 7x and 10x has increased as compared to our prior survey. This may reflect the expanding reach of independent sponsors into more contested auction processes (and related wins of those auctions).



Where are Sponsors Finding Deals?

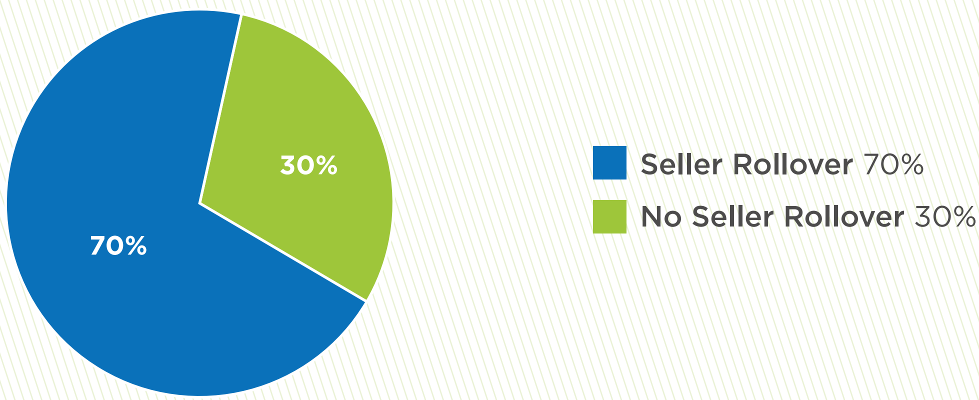
Independent sponsors find deals through a variety of sources. Proprietary relationships combined with direct outreach account for more than 40% of deals secured by independent sponsors. Anecdotally, independent sponsors remain disadvantaged in processes with sophisticated sell-side bankers because (a) sellers are increasingly aware of the unfunded nature of the independent sponsor offer and (b) capital providers may be wary of transactions where the independent sponsor prevailed due to bidding the highest price. The high percentage of responses resulting from proprietary relationships, independent sponsor outreach or maintaining relationships after a broken process suggests to us that independent sponsors play an important role in the market (and hold a competitive advantage) when they source those types of transactions.

Origin of Deal Opportunity



Seller Rollover in Independent Sponsor Deals

Prevalence of Seller Rollover. The capitalization of each transaction alters its dynamics meaningfully, particularly based on the portion of the capitalization represented by rollover investors and the number of capital providers participating in the transaction. Roughly 70% of deals utilized seller rollover equity as a source of funds, which aligns the interests of constituencies and eases some cash funding requirements at closing. Capital providers generally prefer transactions with meaningful seller rollover, absent unique deal dynamics.

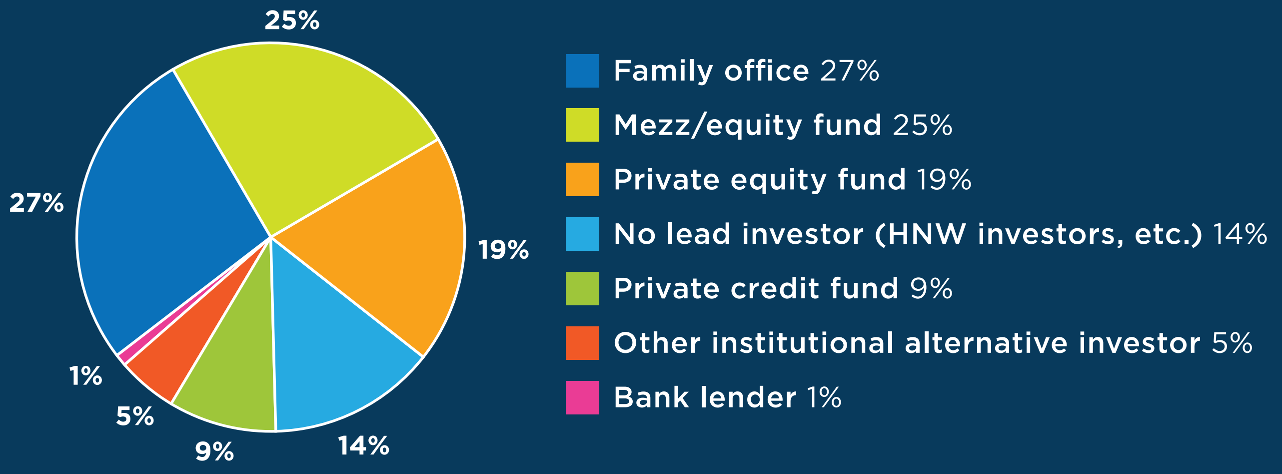


Priority of New Investor Dollars. A sometimes hotly contested issue is whether newly invested dollars from the sponsor's investor group will be senior in priority to equity that the seller has rolled into the transaction. Our survey shows that in only 29% of deals is this the case, with the remaining 71% of deals featuring a pari passu cap table.

Investor Group Dynamics

Most transactions included in this survey were financed with a small number of capital providers, with over 70% of transactions involving only 1-3 institutional capital providers. The independent sponsor market has grown in sophistication and reach since our last survey was published, with a wide array of capital providers investing into the independent sponsor transactions reported in our data. In our experience, the type of lead equity investor in the transaction drives a variety of deal terms based on the leading partner's view of the world as a family office, private equity fund, SBIC fund, etc.

Lead Investor Profile

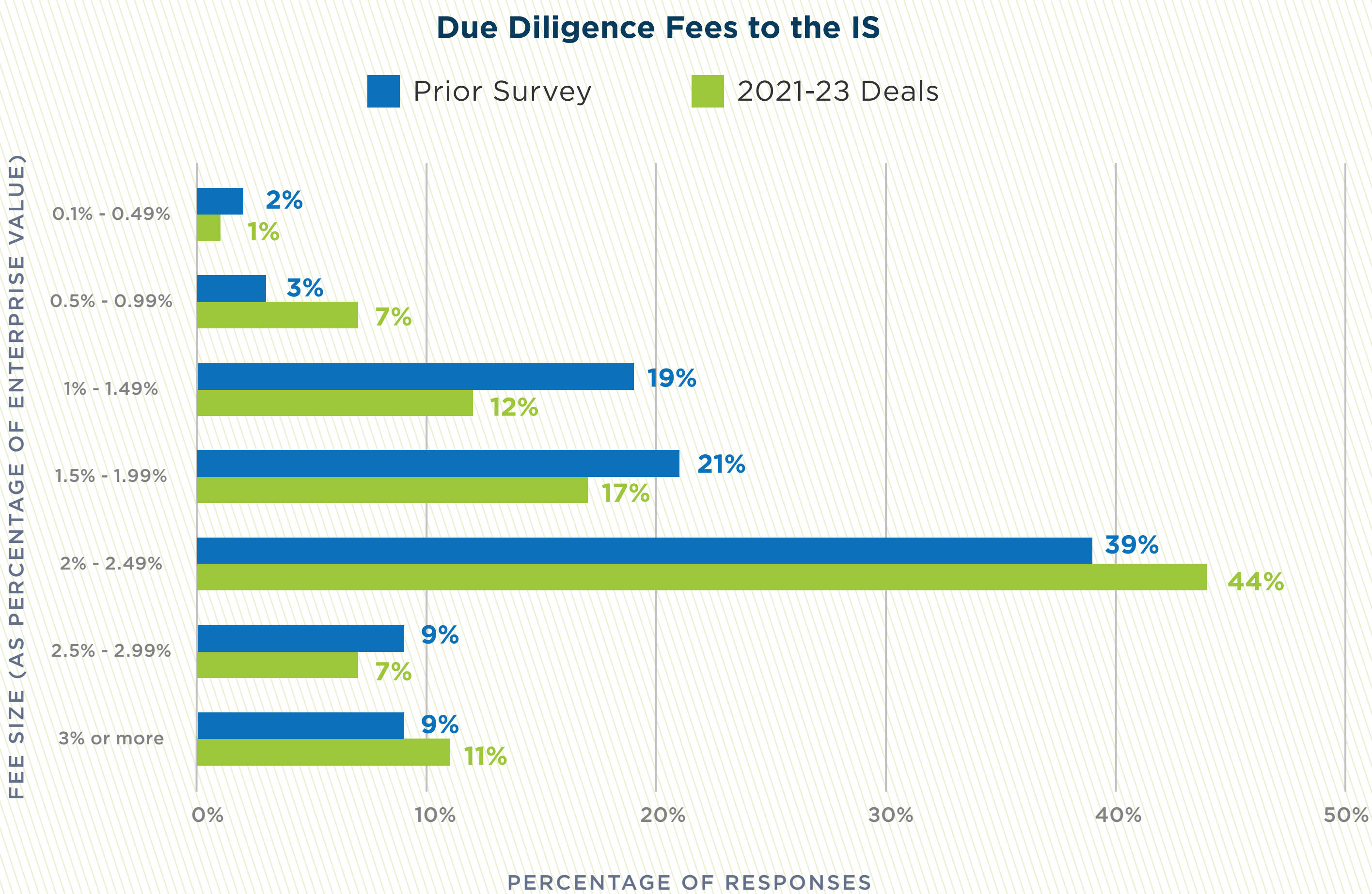


Sponsor Economics

Independent sponsors are typically compensated using a mix of three key elements: (a) a due diligence fee (which may be paid in cash and/or equity in the deal), (b) a management fee (which is on-going from closing until exit) and (c) a carried interest (which is paid out of the proceeds that would otherwise be paid to the equity capital investors). This survey will analyze all three components in detail below.

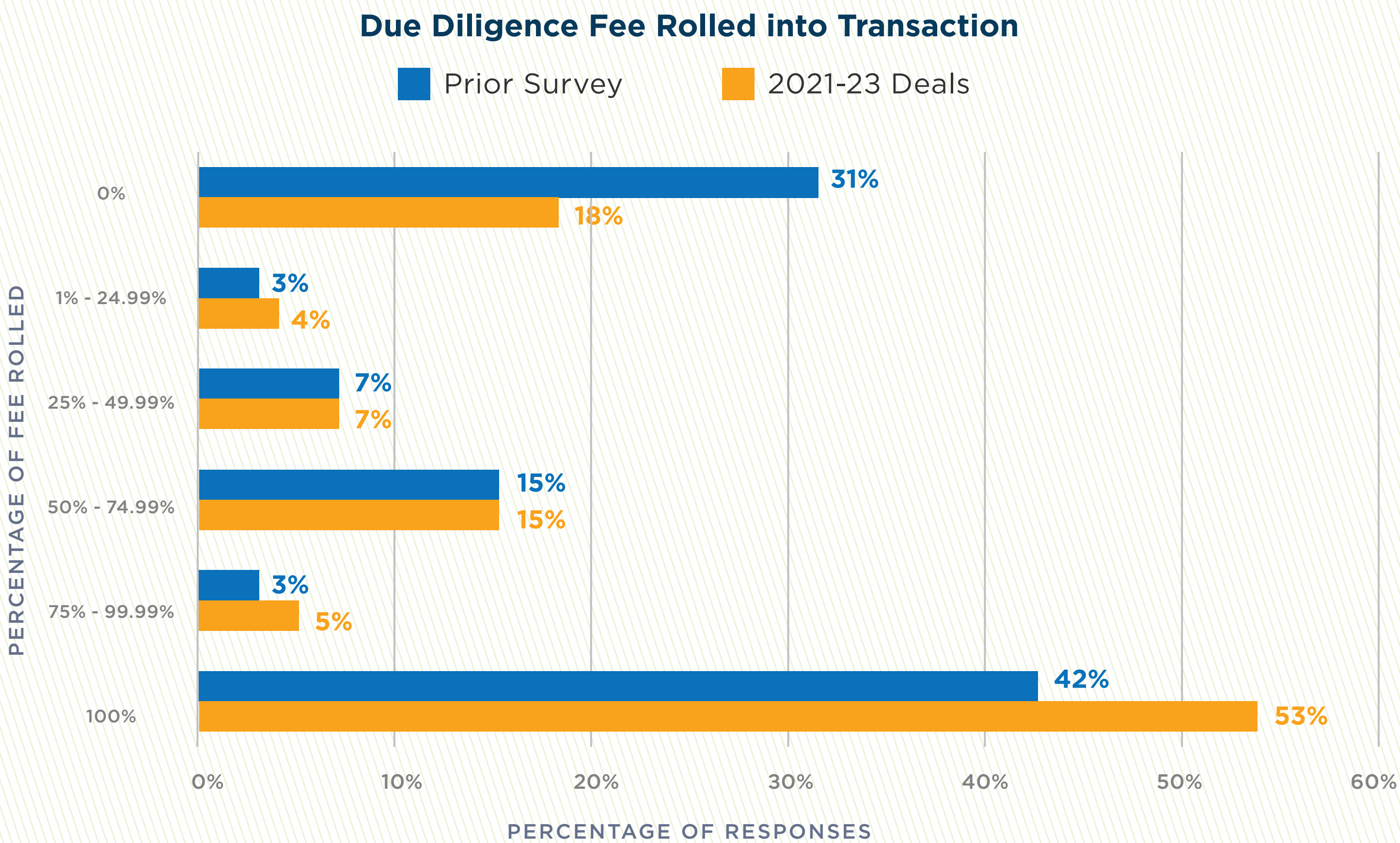
Sponsor Economics – Due Diligence Fee: Size

The economics the independent sponsor receives at closing are one of the three pillars of the typical independent sponsor economic package. This deal study uses the term "due diligence fees" to refer to the amounts paid to the sponsor at the time of the initial closing in exchange for diligence and structuring work related to the initial acquisition (but the fee can take a variety of forms, as we explore below). A due diligence fee within the range of 2.00-2.49% of enterprise value has become the dominant market position in lower middle market transactions. Unsurprisingly, as deal sizes increase, the fee size as a relative percentage of enterprise value tends to decrease.



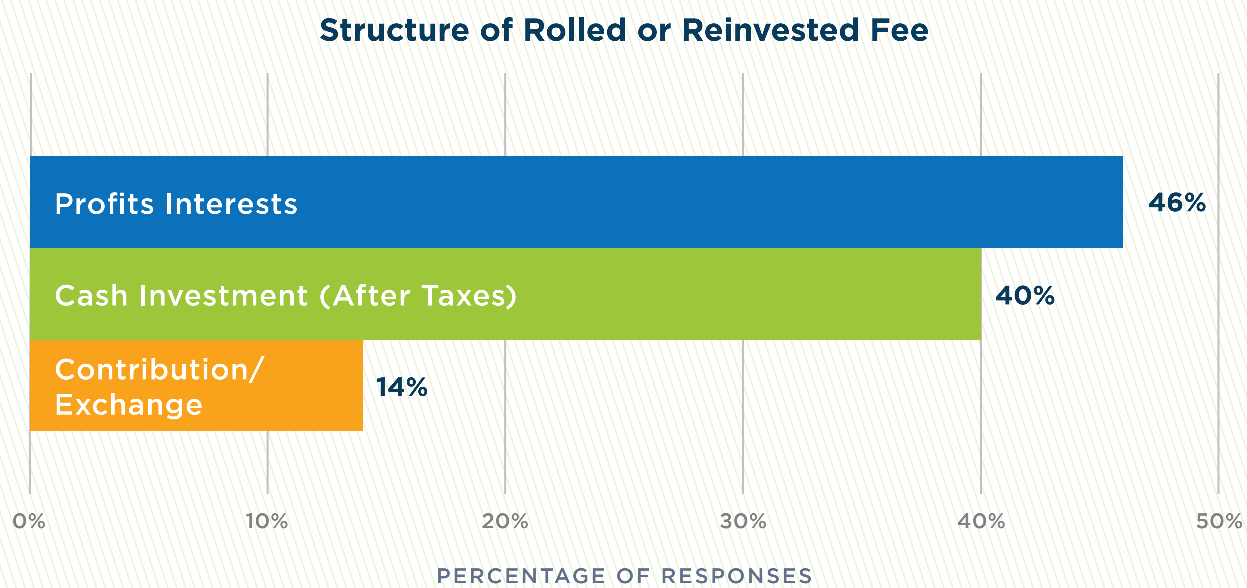
The due diligence fee is almost universally (91%) calculated by reference to the enterprise value of the target (rather than the amount of capital raised or invested).

Independent sponsors generally rolled more than half of their due diligence fees into equity in the transaction, with a rollover of 100% of the fee being the most common result. Reinvested due diligence fees reflect independent sponsors' confidence in their deals as well as equity investors' preference that at least a portion of the fee be reinvested into the transaction.



Sponsor Economics - Due Diligence Fees: Structure

Due Diligence Fees for Independent Sponsors. At closing, there are a variety of ways to structure these closing economics in consideration of the independent sponsor's pre-closing and short-term post-closing efforts. Examples include: (1) payment of a due diligence fees in cash and reimbursement of expenses, (2) profits interest units granted to the independent sponsor at or in connection with the closing (which generally sit immediately behind return of capital in the distribution waterfall but feature a "catch up"), and (3) pari passu equity issued to the independent sponsor in exchange for the contribution of equivalent value. The survey shows that granting a profits interest or including a cash investment with after-tax dollars are the dominant approaches. Less common (and often riskier from a tax perspective) is the contribution of equivalent value in exchange for equity. The structure of the due diligence fees implicates tax, regulatory and licensing considerations, so the independent sponsor should consult knowledgeable legal counsel prior to structuring, documenting or accepting any due diligence fees.

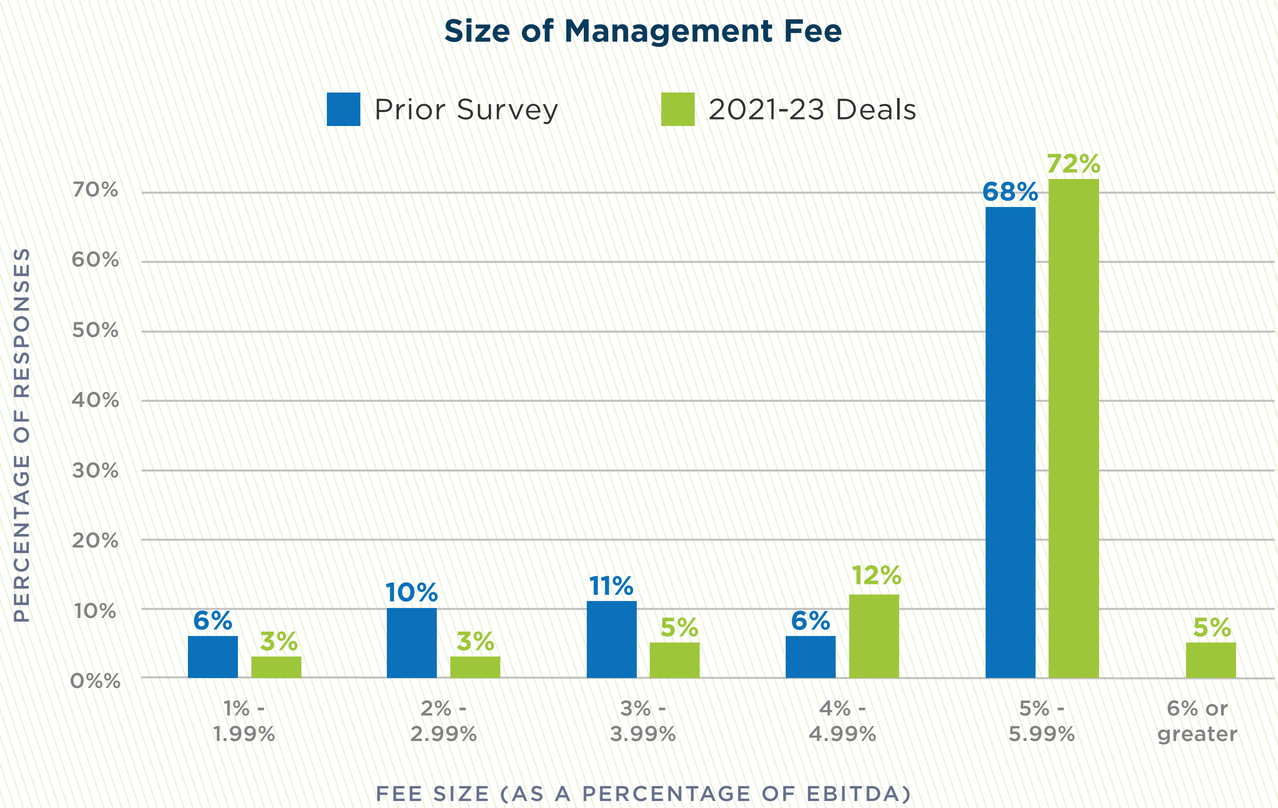


Due Diligence Fees for Capital Partners. The equity investors participating in the transaction received no fees in more than 77% of the transactions reported (up from 60% in our prior survey). It should be noted, however, that the prevalence of equity investors receiving fees varied significantly by the type and number of equity investors.

Sponsor Economics - Management Fees: Overview

The management fee is the second of the three pillars of independent sponsor economics. The management fee is a fee paid by the portfolio company to the independent sponsor for consulting, management and similar services during periods following the closing of the acquisition of the portfolio company. The management fee is most often paid on a quarterly basis. As with other private equity investments, management fees provide an ongoing source of income for an independent sponsor to pay for its internal operational costs and expenses.

Of transactions with management fees, roughly 75% were calculated based on the trailing 12-month EBITDA of the portfolio company, as opposed to a fixed dollar amount. A management fee based on 5% of TTM EBITDA has become the default choice in such EBITDA-based structures in lower middle market transactions.

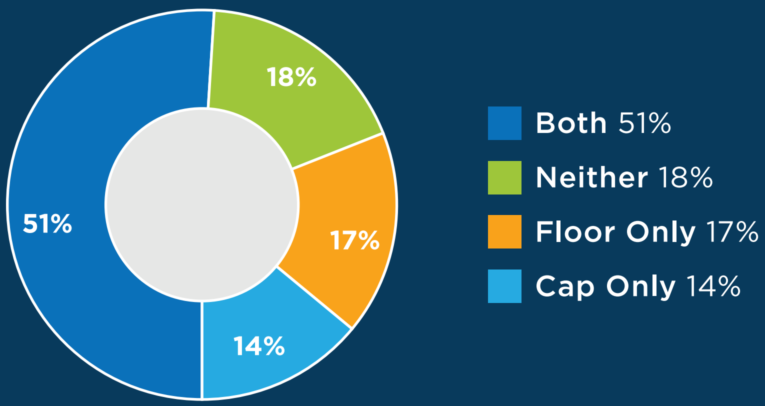


Sponsor Economics- Management Fees: Additional Considerations

Floors and Caps. Importantly, management fees are often subject to a minimum and/or maximum amount, and those floors and caps most often are fixed dollar amounts, instead of percentages of TTM EBITDA. More specifically, 68% of transactions surveyed included a floor for management fees, and 65% included a cap on management fees. The matrix below provides a useful illustration of dollar ranges for those deals that featured both a cap and a floor, though the size of fee caps and floors tends to increase on a linear basis with the size of the deal/platform company.

Annual Management Fee Floors and Caps

Was There A Floor and/or Cap on the Annual Management Fee to the IS?

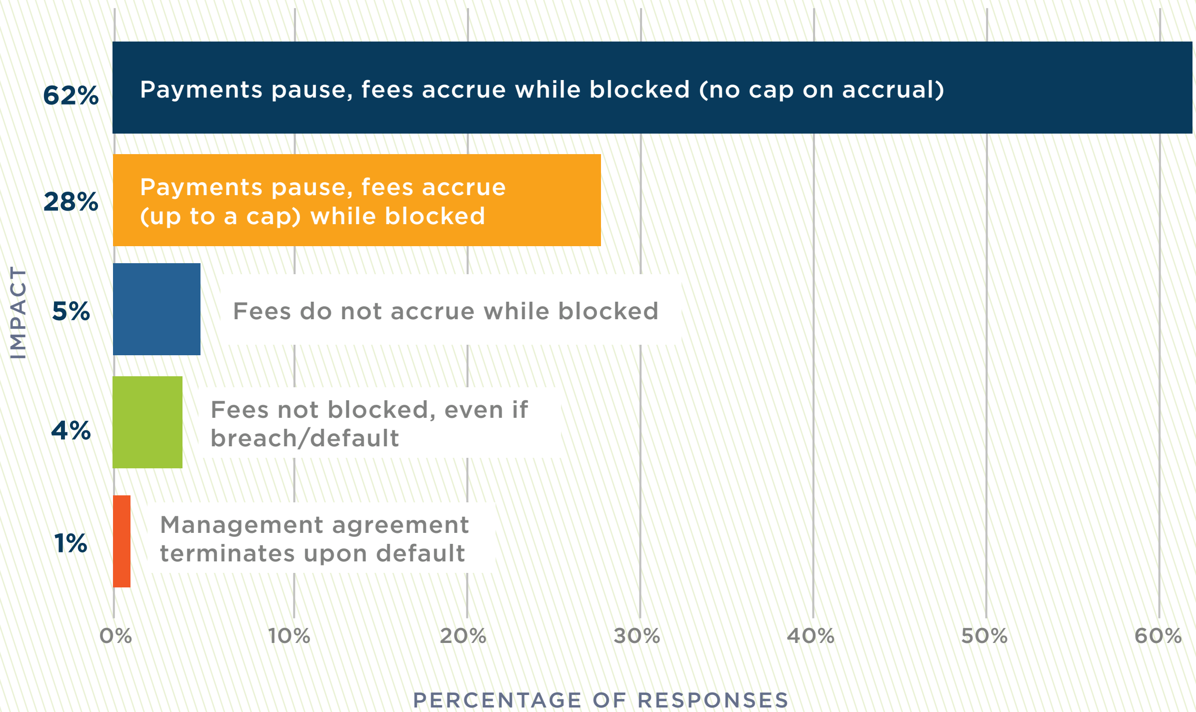


Management Fees to Capital Providers. Capital providers were rarely paid on-going management fees in connection with their equity investment, with only 14% of responses including such fees (down from 25% in our prior data). This data continues to reflect a broad theme of independent sponsors truly adding value rather than merely being brokers or finders. Moreover, it illustrates the value equity investors ascribe to the independent sponsor's post-closing efforts and the value proposition of independent sponsor-led transactions for all sorts of investors, particularly family offices and other investors who are not actively involved in the operations of the portfolio company following the closing.

Sponsor Economics – Management Fees: Subordination

Management fees are usually subordinate to the portfolio company's senior and mezzanine debt, if any, and payments of the management fee are generally restricted if the portfolio company is not in compliance with its debt covenants. In more than 85% of leveraged transactions, payments of the management fee paused while not permitted by the credit agreement, which is consistent with our prior survey.

Impact of Credit Agreement Noncompliance on Management Fees



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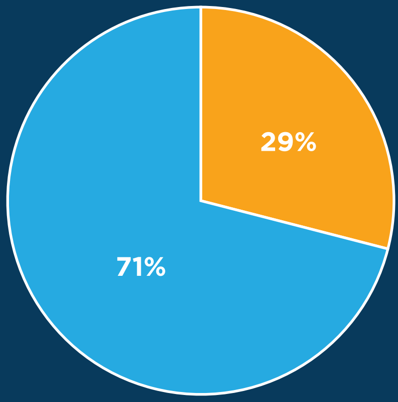
Sponsor Economics - Carried Interest: General Matters

Carried interest is the independent sponsor's share of profits that otherwise would have been paid to the equity capital investors in respect of their equity securities. Carried interest (otherwise known as "carry" or "promote") is the third pillar of the independent sponsor economic package. Carried interest is usually documented in the distribution waterfall provisions of the limited liability company agreement of the holding company for the investment or in a separate carry entity that invests directly into the holding company.

There are two basic models for the independent sponsor's carried interest: (1) a "variable-with-hurdles" model with multiple escalating hurdles (typically based on multiple on invested capital (MOIC) and/or internal rate of return (IRR)) hurdles that, once achieved, result in an increasing percentage of the profits being allocated to the independent sponsor; and (2) a "straight percentage" model in which, following a return of capital to equity investors and often a preferred return, the independent sponsor receives a straight percentage of profits.

Of the transactions surveyed, over 71% use the variable-with-hurdles model, which represents a 10-point increase from the 61% reported in our prior survey and illustrates the continued shift to a true "independent sponsor model" of economics. In our view, the variable hurdle model, while being more complex, better aligns incentives of sponsors and capital partners in both the downside and upside scenarios.

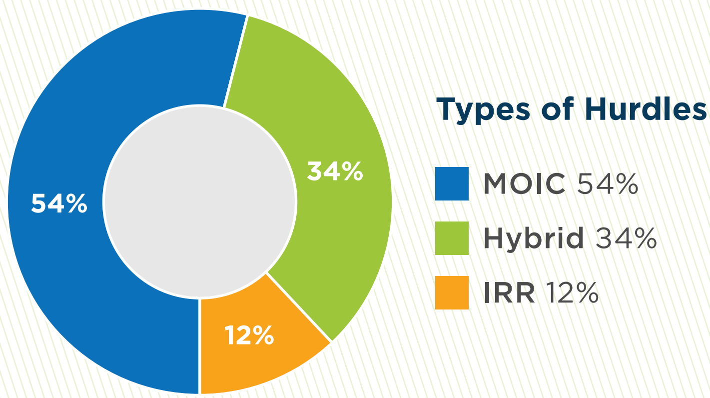


Carried Interest Models

- **Variable Percentage** 71%
- **Straight Percentage** 29%

Sponsor Economics - Carried Interest: Hurdles in the Variable Percentage Model

The hurdles in the variable percentage model customarily are calculated based on distributions of proceeds that equity investors received in respect of their equity investment, excluding any debt investments, return of capital, management fees, closing economics or expense reimbursement (but see further below for discussion on tax distributions). Hurdles are typically calculated using MOIC and/or IRR metrics. MOIC is the most common measure, as compared to IRR and hybrid approaches. Hybrid models take varying shapes, the most common of which are (1) hurdles that include both IRR and MOIC metrics at each stage of the waterfall, and (2) switching from MOIC to IRR hurdles after a certain time period.

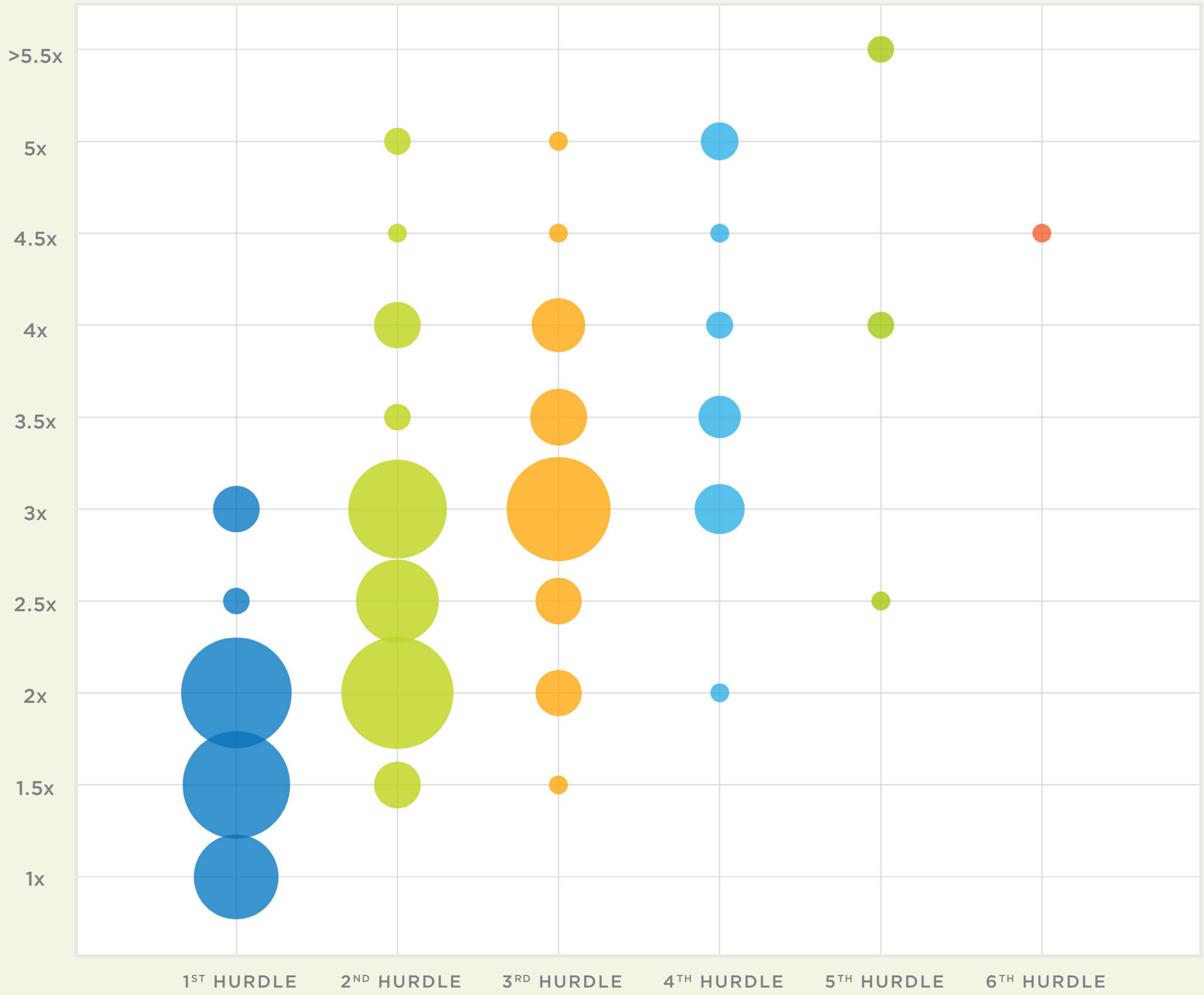


We note that MOIC is becoming less dominant as the standard hurdle measure (70% of deals in last survey as compared to 54% of deals in this survey), with hybrid hurdles jumping in popularity from 17% to 34%. This dual hurdle provides greater protection to capital partners in longer hold scenarios that produce relatively low IRR.

Sponsor Economics - Carried Interest: Heat Maps of Hurdles and Return Percentages

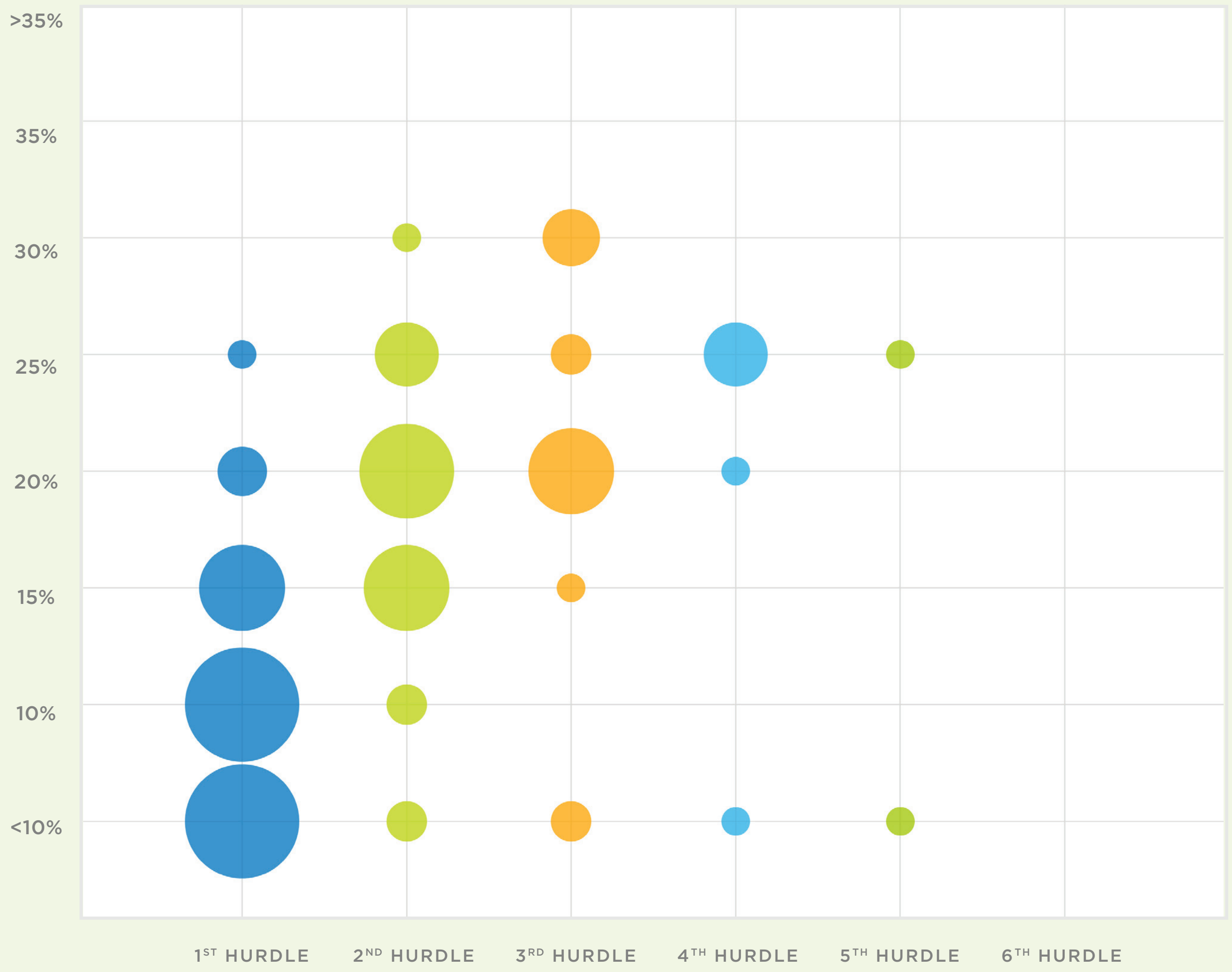
Below are heat maps of (A) responses that utilized either MOIC hurdles or hybrid hurdles (with results being based off the MOIC component) and (B) responses that utilized IRR hurdles only. In our experience, the final negotiated outcome of hurdles and associated returns are highly deal-specific (based on quality of deal) and also highly sponsor-specific (based on prioritization of "home run" economics vs. earlier economics), but these heat maps provide a general sense of where these key economic points are landing in the market. The first two heat maps depict the levels at which hurdles are being set in independent sponsor deals, and the final two heat maps illustrate the carried interest percentages that independent sponsors are receiving upon the achievement of such hurdles.

MOIC Hurdle Thresholds



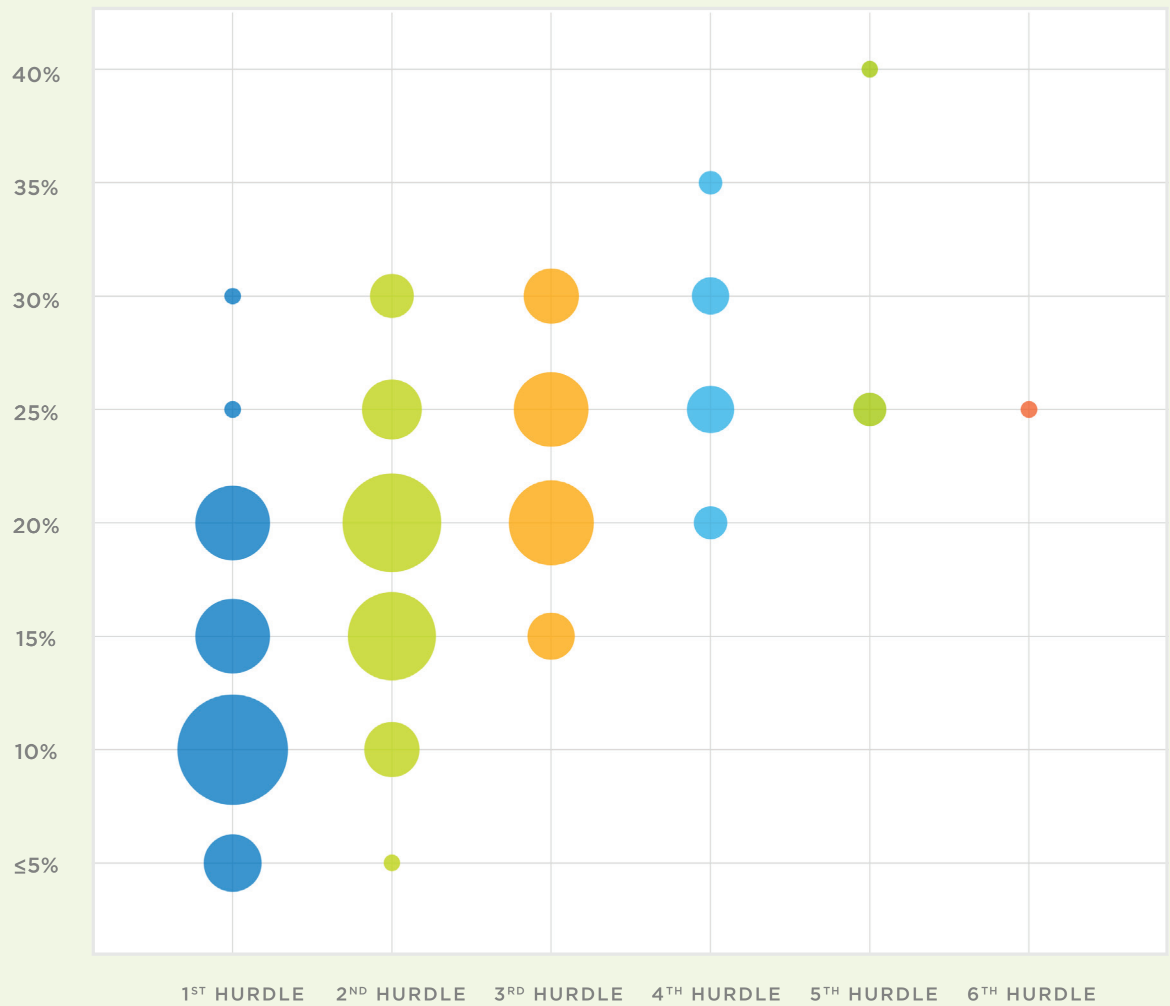
Hurdles, whether based on IRR or MOIC, are typically calculated based on distributions and other proceeds equity investors received in respect of their equity securities, excluding any debt investments, management fees, closing economics or expense reimbursement.

IRR Hurdle Thresholds



The following two heat maps illustrate the percentage returns to the independent sponsor upon achieving the various hurdles in the waterfall (which were described in the prior two slides).

MOIC Return Percentages



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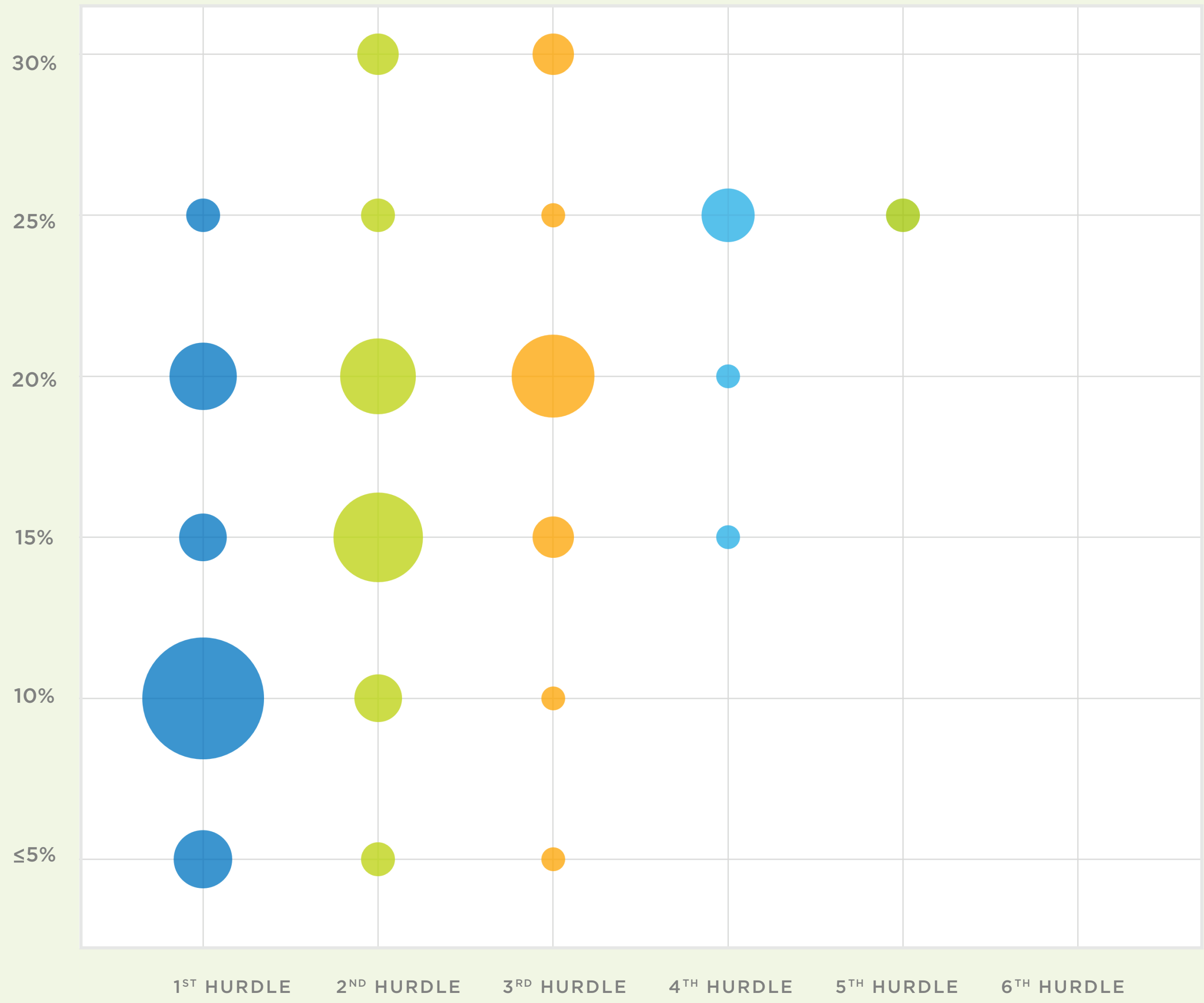
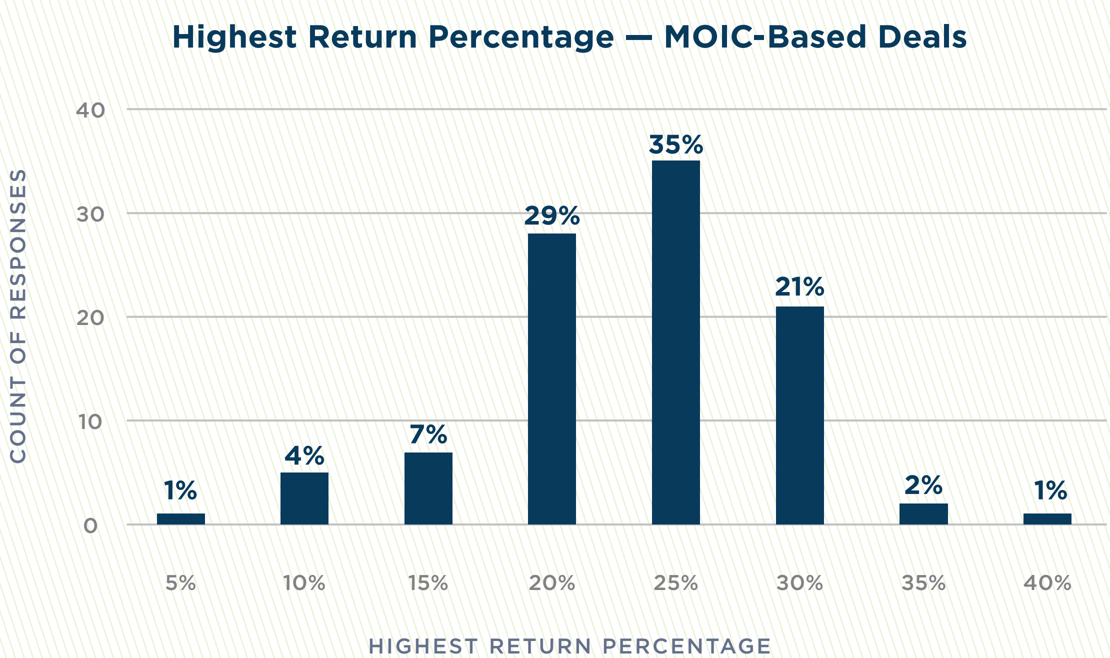
In our experience, the quantum of the highest carry percentage is influenced by the quality of the deal, the competitive dynamics of the equity capital negotiations, the profile of the lead capital partner, and the quantum of distributions required to achieve the hurdle.

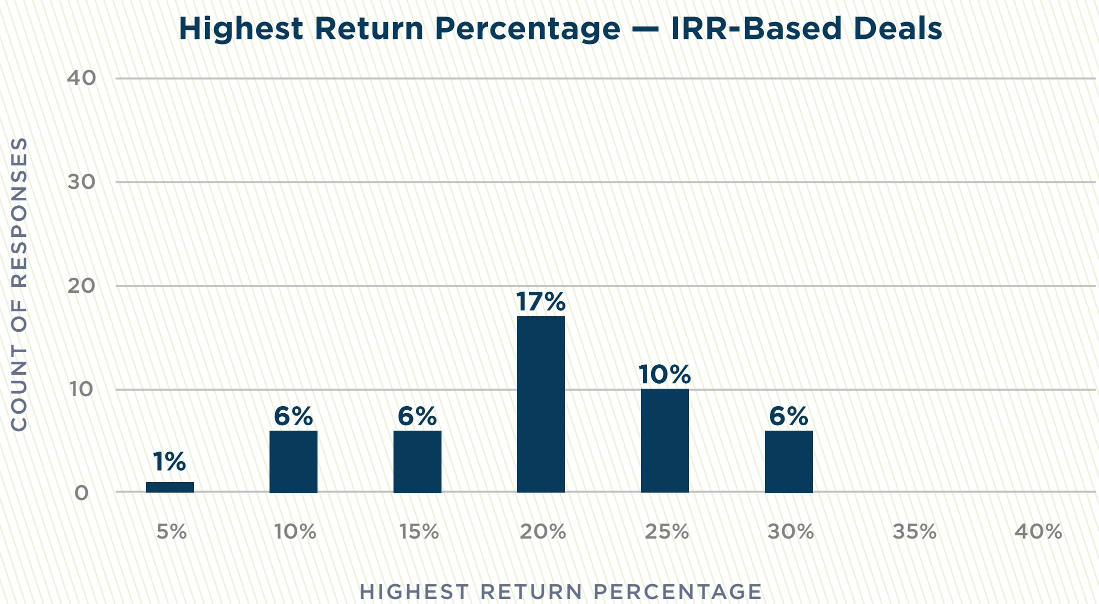
IRR Return Percentages



Sponsor Economics – Carried Interest: Maximum Variable Percentage Hurdles

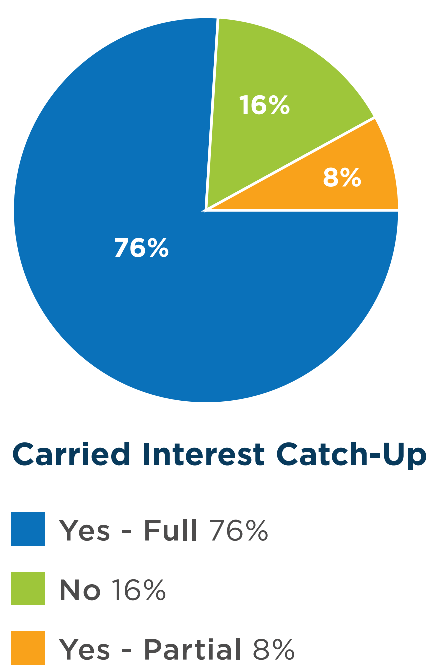
Sponsors who are confident in the upside scenario of a transaction will often be very focused on the highest variable percentage capital providers are willing to pay. While this information does not capture the full picture of the various hurdles, catch-ups, fees, etc., it can serve as a useful shorthand metric. Overall, independent sponsors are earning significant top-end economics in the variable percentage model, which shows that in significant upside scenarios investors are willing reward the sponsor who sourced and led the deal. Interestingly, the results are less sponsor-friendly when IRR is used as the hurdle metric, perhaps reflecting that in an IRR model the outsized return scenarios (e.g., 5x) are less of a focus than a steady return over time.





Sponsor Economics – Carried Interest: Catch-Up to Independent Sponsors

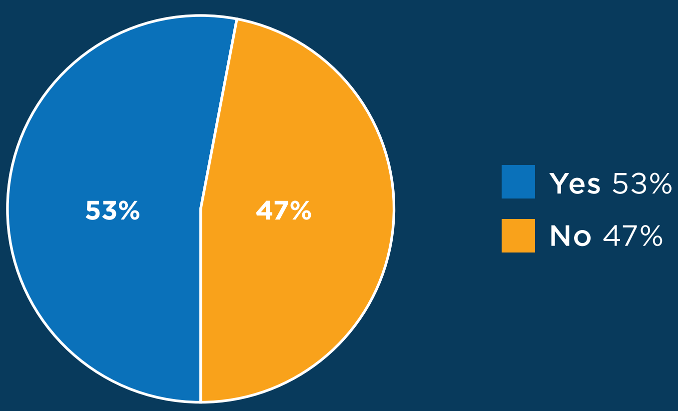
The survey responses revealed that the vast majority of independent sponsor transactions continue to be structured with catch-up steps in the waterfall. Catch-ups match the independent sponsor's carry to the applicable percentage of all profits (rather than just the incremental sharing after the applicable hurdle has been cleared). Full catch-ups provide the independent sponsor with full participation at every incremental hurdle, taking into account all profits from the first dollar of profits. Full catch-up structures remain the dominant position (and increased incrementally from our prior data). Partial catch-ups are structured so that the independent sponsor (i) does not catch up to the first dollar of profits and/or (ii) does not fully catch-up to one or more higher carried interest percentages. When a partial catch-up structure is used, the most common approach was for the independent sponsor to not receive full catch-up payments only on the final hurdle.



Sponsor Economics - Carried Interest: Other Considerations

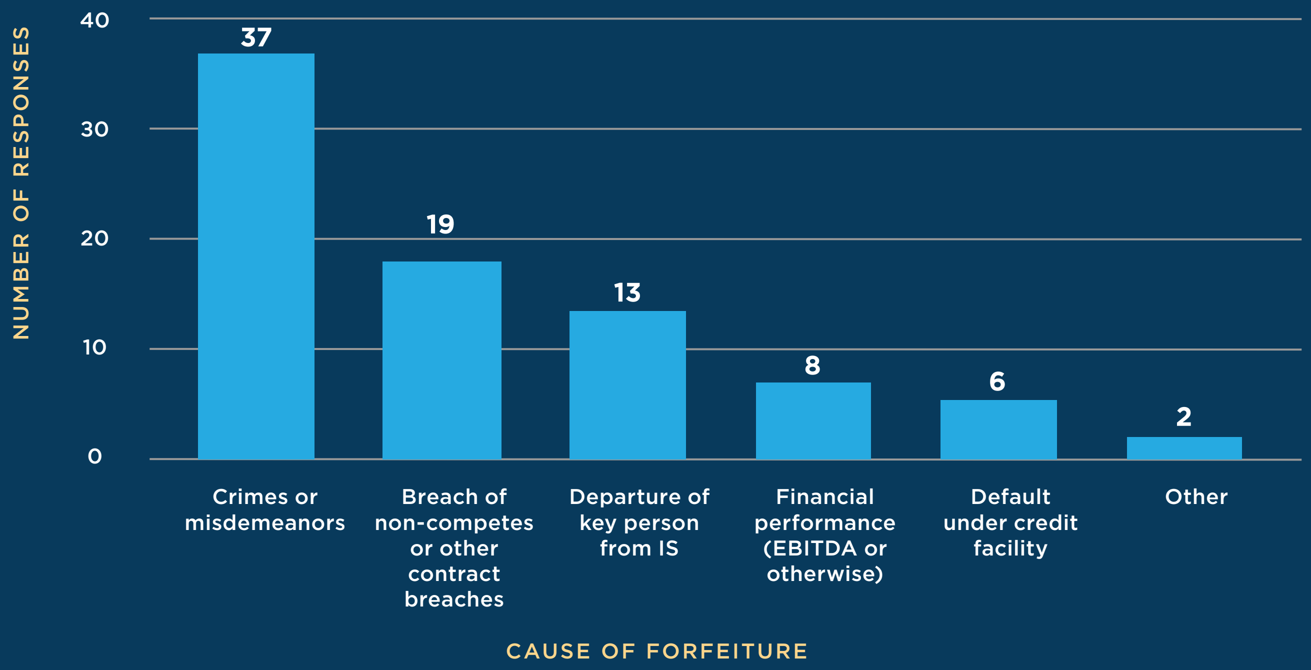
Tax Distributions. Most respondents utilized a flow-through tax structure with respect to their investment vehicles, which raises the important question of whether tax distributions (required in flow-through settings to avoid "dry income") received by investors during the hold period count towards the various MOIC and IRR hurdles described above. As seen below, there is no consensus on this point. We note, however, a significant number of platforms (23%) utilized a c-corp "blocked" structure, which largely avoids this tax distribution issue (but has other important considerations that are beyond the scope of this survey).

Did Tax Distributions Count Towards Carried Interest Hurdles?



Forfeiture of Carried Interest. In the vast majority of deals (75%), the carried interest of an independent sponsor was not subject to any forfeiture provisions. Of the minority of deals that included forfeiture of carried interest, we note that most of the forfeiture provisions related to items that are within the direct control of the independent sponsor and are serious in nature, such as the commission of crimes, departure of a key person from the sponsor entity, or breaches of non-competes.

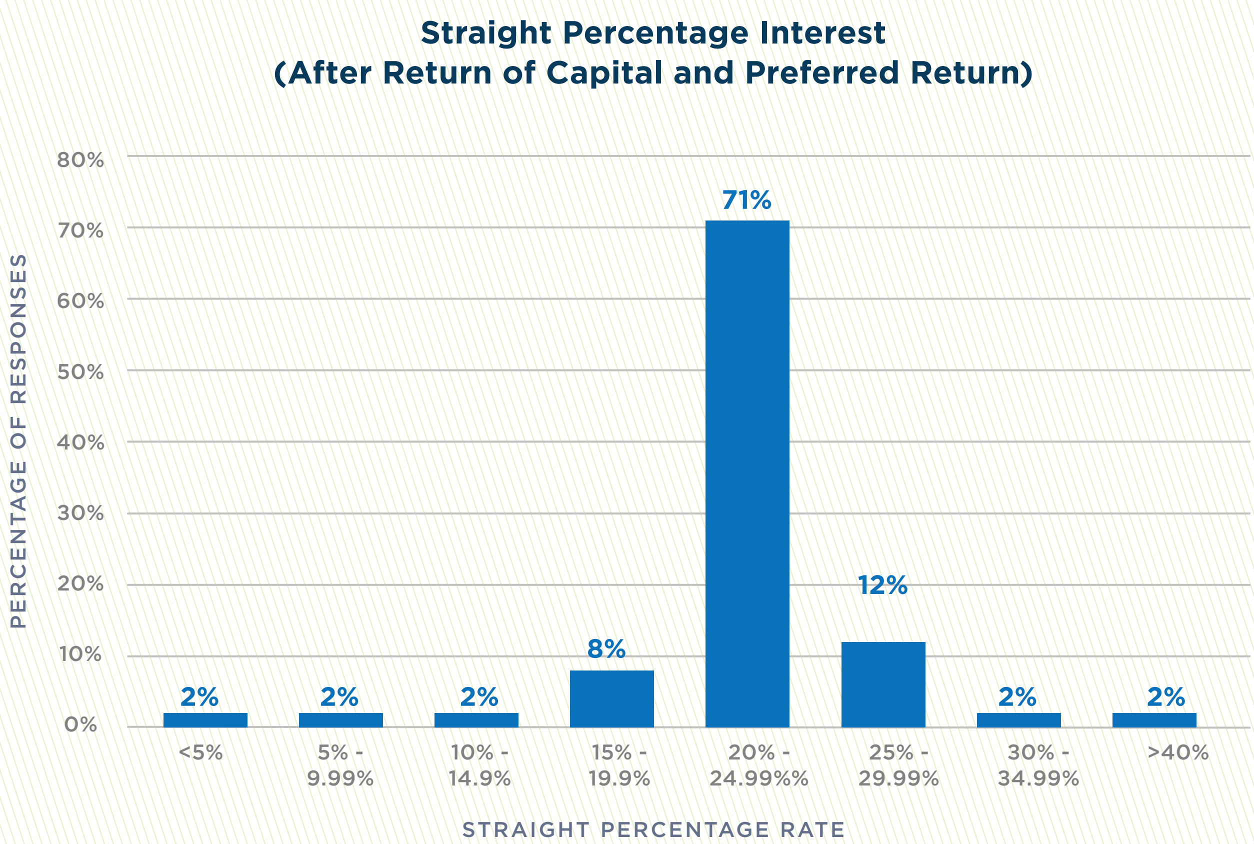
Trigger Events for Forfeiture of Promote



Only a small handful of applicable transactions included forfeiture of carried interest that was tied to events outside the direct control of the independent sponsor (e.g., default under credit facility or other financial performance issues). In our view the market approach is a logical one: while a management fee is paid for ongoing services (and more directly ties to underperformance of management during the course of the hold period), the carried interest reflects the agreed allocation of upside at the time the investment is made and inherently punishes underperformance by virtue of the various hurdles discussed above.

Sponsor Economics - Carried Interest: Straight-Percentage Model

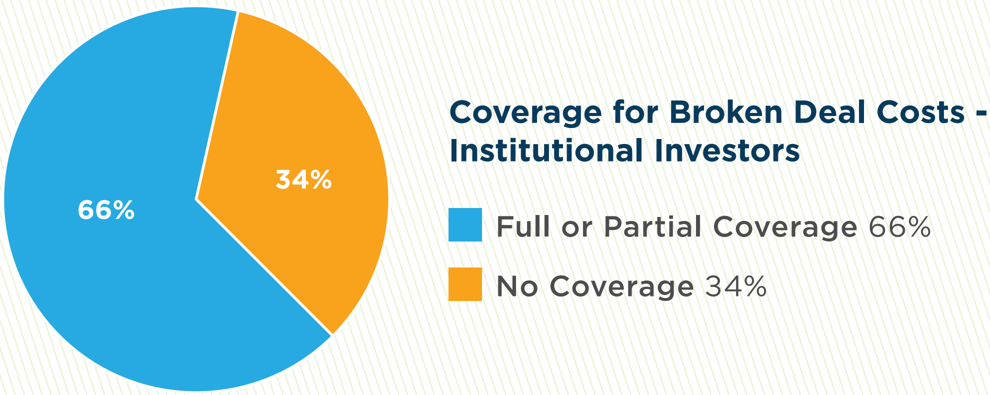
Of the transactions surveyed, less than 30% used the straight-percentage model. Transactions with no lead capital partner skewed towards the straight-percentage model (45% of such transactions). This is consistent with our experience, as it is not uncommon for “pass-the-hat” equity financings to use the straight-percentage model due to simplicity of negotiations as well as historical acceptance of the “two and twenty” model. Virtually all straight-percentage models had a carried interest between 15% and 25% and paid a preferred return of 8%.



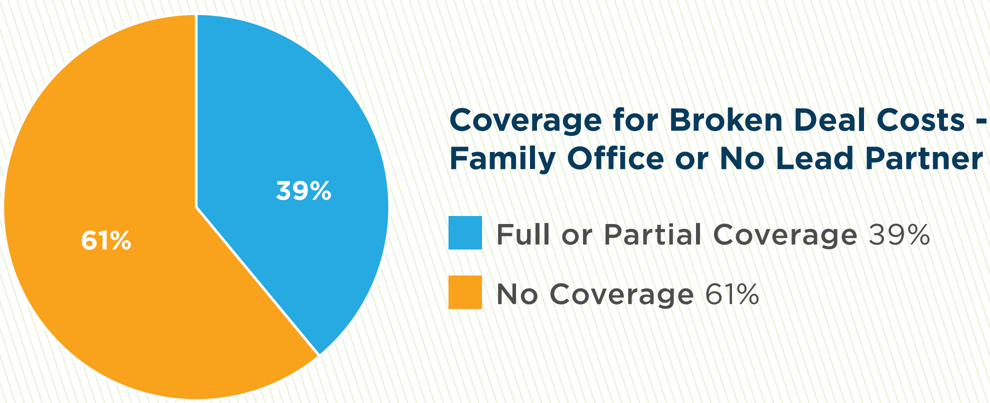
Broken Deal Expenses

An important element of a capital provider's partnership is the treatment of broken deal expenses, including quality of earnings and legal costs incurred before negotiations terminate. Equity capital partners provided partial or complete coverage of broken deal expenses in most transactions, often in exchange for partial or complete exclusivity related to the capital investment. Transactions without broken deal expense sharing were often those with an independent sponsor that was unwilling to provide exclusivity or preferred to close with a consortium of capital providers.

The data show that the private equity funds, mezzanine debt funds, private credit funds and other institutional investors often provide expense reimbursement to independent sponsors.



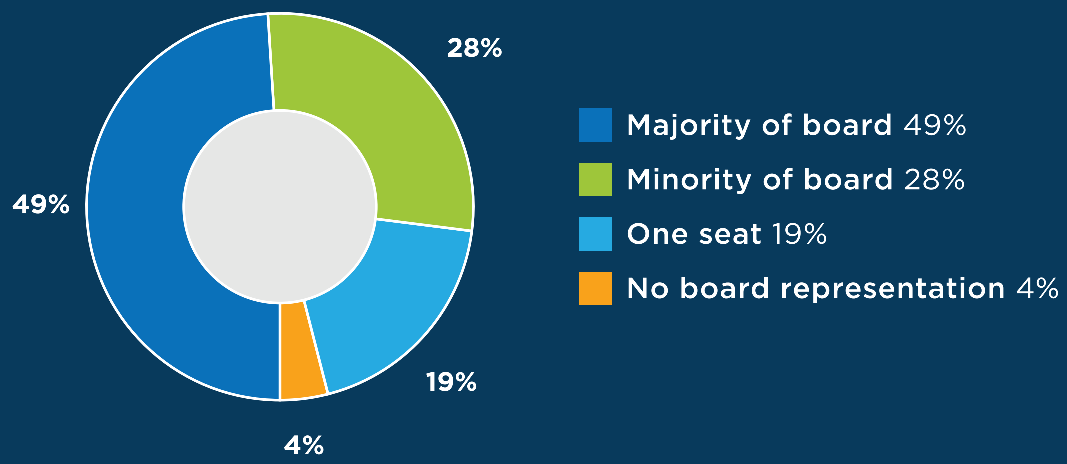
By contrast, sponsors are less likely to receive broken deal coverage when there is no lead investor or when the lead investor is a family office. When there are many investors with no lead, it is of course structurally more difficult to obtain expense coverage from a multitude of investors. It is unclear why family offices are less inclined to provide expense coverage, but one can speculate that a subset of family offices have less exposure to independent sponsors as an asset class and are less familiar with "what's market." In deals with no broken-deal cost coverage, it is critical for independent sponsors to carefully stage their spending with third-party advisors and to work with advisors who will take a partnership approach to such expenses.



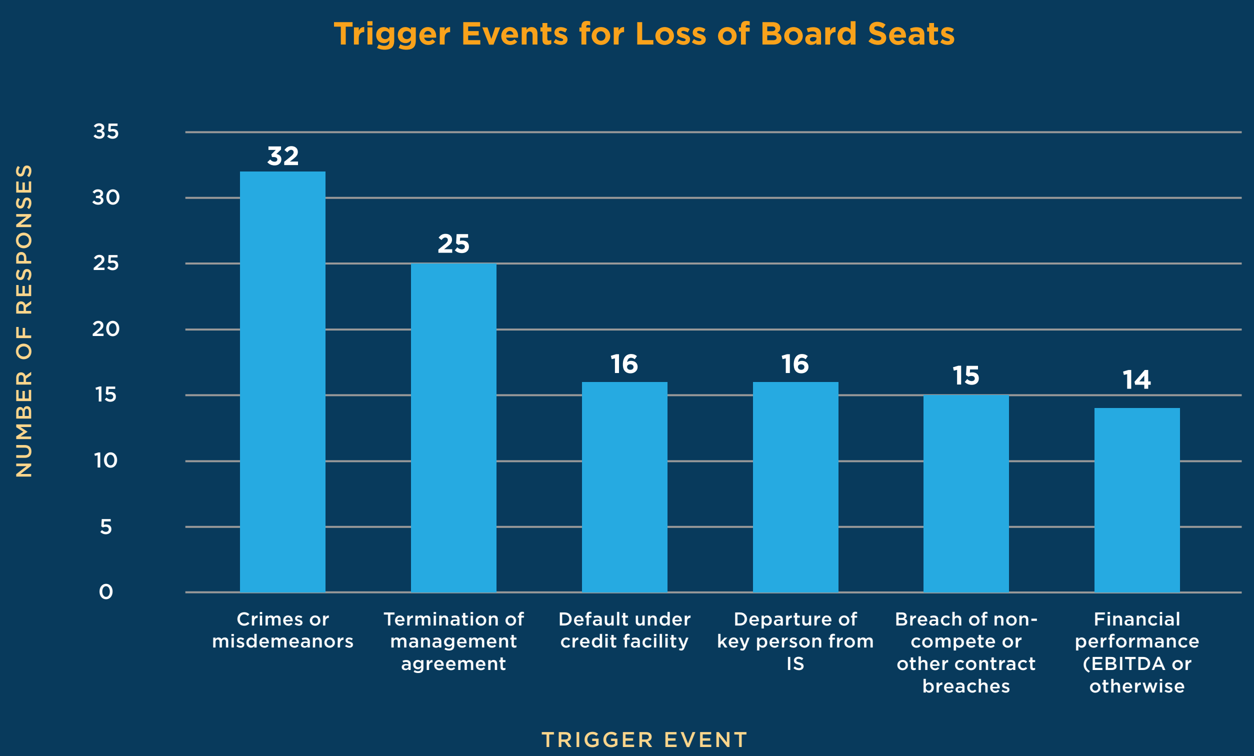
Board Matters

Board control remains a highly deal-specific dynamic, with no "one size fits all" approach. Multiple constituencies such as the equity capital partner(s), the independent sponsor and the rollover sellers might each seek varying levels of representation on the board. The data show it is basically a 50/50 proposition as to whether the independent sponsor will control the board or not. Private equity and mezzanine debt and equity funds were more likely to require board control, and family office and syndicated capital groups were more likely to enable the independent sponsor to control the board. Note, however, that these trends do not account for the control exerted through blocking rights required when an independent sponsor has board control.

Board Representation for the Independent Sponsor



It is not uncommon for equity capital partners to subject the sponsor's board control to a list of trigger events that, if they occur, result in the capital partner taking control of the board. Out of the deals that initially provided the independent sponsor with board control, 29% included these "board flip" mechanics. The chart below lists the most common trigger events that would cause the sponsor to lose board control.



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Conclusion

Independent sponsors, as an asset class, have experienced prolific growth over the past decade and have established themselves as a critical component of the private equity industry. This growth can be seen first-hand at the annual McGuireWoods Independent Sponsor Conference in Dallas, which began in 2017 with 317 attendees and in 2024 welcomed over 1,600 independent sponsors and capital partners.

The results of this study suggest there are no signs of independent sponsor-led deals slowing down. The independent sponsor community continues to increase in sophistication and professionalization, with an increasing number of funds raised specifically to invest in independent sponsor transactions and a growing body of other private investors who want to participate in independent sponsor deals. Such investors are seeking exposure to entrepreneurial sponsors who are primarily investing in founder-owned businesses in the lower half of the middle-market and then truly transforming those businesses post-closing. We think this is a durable and winning playbook, with no shortage of target companies or available capital. We look forward with enthusiasm to further expansion of the independent sponsor model and hope that this survey plays a small part in its growth by helping participants understand terms prevalent in the independent sponsor segment of private equity.

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For further insights on independent sponsor issues and transactions, please listen to McGuireWoods' independent sponsor podcast "Deal-by-Deal", hosted by private equity partners Jeff Brooker, and Greg Hawver, available on **YouTube** and the **McGuireWoods website** as well as **Apple Podcast** and **Amazon**.

Independent Sponsor Conference

For additional resources and thought leadership related to independent sponsor transactions as well as information on the industry-leading annual McGuireWoods Independent Sponsor Conference in Dallas, please visit **independentsponsorconference.com**.

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